Internal Revenue Service

memorandum

CC:TL-N-8996-87
Br1:HFRogers

date: AUG 12 1987

to: District Counsel, San Jose CC:SJ

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice dated July 1, 1987.

ISSUE

Whether to pay the $[redacted] in litigation costs and attorney's fees requested by the petitioners pursuant to I.R.C. §7430. 7430.00-00

CONCLUSION

We concur in your recommendation that the case be settled. Given the facts in the instant case, it would not be an appropriate litigating vehicle with which to advance the Service contention regarding "position of the United States" at the administrative level in TEFRA partnership cases. However, in light of Sher v. Commissioner, 89 T.C. No. 9 (July 9, 1987), we recommend that the settlement be for less than the requested amount.

FACTS

Following is a chronology of the pertinent events in the above subject case:

[redacted] Notice of deficiency sent to petitioners
[redacted] Notice of final partnership adjustment sent to tax matters partner
[redacted] Petition filed
[redacted] Answer filed
[redacted] Appeals officer assigned
[redacted] Note under proposed taxes reads "pending outcome of appeal on TEFRA p/s"
[redacted] Respondent filed a motion to dismiss for lack of jurisdiction
[redacted] Motion granted
[redacted] Motion for award of litigation costs filed

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The petition does not mention that the case is subject to the TEFRA provisions of the Internal Revenue Code. The notice of deficiency determined a deficiency in the petitioners [redacted] income tax based solely upon an adjustment of partnership items. Once it was brought to the District Counsel attorney's attention that the TEFRA provisions might apply to this case, it was speedily determined that the issuance of the notice of deficiency in this case was erroneous. This determination was made, in part, because the partnership's Form 1065 for taxable year [redacted] indicates that the partnership began operating its business during [redacted].

DISCUSSION

Section 7430 authorizes the award of reasonable litigation costs to taxpayers in certain circumstances.*/ Under section 7430, in order to be entitled to an award of litigation costs, the taxpayer must:

(1) substantially prevail in the litigation (section 7430(c)(2)(A)(ii));
(2) establish that respondent's position is not substantially justified (section 7430(c)(2)(A)(i)); and
(3) have exhausted the administrative remedies available to that taxpayer in the Internal Revenue Service (section 7430(b)(2)).

See Minahan v. Commissioner, 88 T.C. 492 (1987)

1. Substantially Prevail

In the instant case, the taxpayers have substantially prevailed. The Service has conceded that the notice of deficiency should not have been mailed in the instant case because the partnership at issue was subject to the TEFRA provisions.

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*/ We agree that section 7430(c)(1)(A)(III) limits reasonable attorney fees to $75 per hour unless the court determines that an increase in the cost of living or a special factor justifies a higher rate. Therefore, we concur with your determination that petitioners would, at the most, be entitled to $[redacted] in legal fees and the $60 filing fee rather than the $[redacted] in legal fees they originally requested.

2. Substantial Justification

In light of the opinion in Sher v. Commissioner, supra, it is questionable whether the petitioners could establish that the position of the United States was not substantially justified. The court in Sher examined the definition of "position of the United States" provided in section 7430(c)(4). This section provides that the "position of the United States" includes:

(A) the position taken by the Unites States in the civil proceeding, and
(B) any administrative action or inaction by the District Counsel of the Internal Revenue Service (and all subsequent administrative action or inaction) upon which such proceeding is based. (Emphasis in the original.)

[Slip op. at 11-12.]

The court concluded "under the statute our application of the substantially justified standard to administrative actions or inactions prior to the institution of a proceeding is limited to the period at which District Counsel has become involved." Slip op. at 12. The court found, as would be the case in the instant situation, that the District Counsel first became involved in the case by answering the petition.

Numerous unreported cases have held that the Service is not substantially justified when it takes too long to correct its errors after the suit is filed. See, e.g., Hanes v. United States, No. 84-2626 (9th Cir. 1984); Offut v. United States, (E.D. Va. 1985); Shawver v. United States, (N.D. Iowa 1985). In the instant case, there is no indication of when the trial attorney was first contacted regarding the possibility of this case being subject to the TEFRA provisions. To the best of his recollection, as soon as he was contacted, he investigated, determined the notice of deficiency should not have been sent to the petitioners, and filed the motion to dismiss. In that case, the position of the United States would be substantially justified.

However, there is cause for concern where the administrative file indicates the Appeals officer knew that there was a question about whether TEFRA applied as early as [redacted]. Also, there is a copy of the notice of final partnership adjustment in the administrative file. At the time the answer in the instant case was filed, District Counsel did not have the administrative file to use in preparing the answer. The court could determine the Service's position was not substantially

justified in not reviewing the administrative file before filing the answer in the instant case. Apparently, a review of the administrative file would have put the Service on notice about the potential problem so it could have been investigated sooner.

There is also cause for concern because District Counsel routinely advises the Service Center to issue the notice of deficiency to the partners and the notice of final partnership adjustment at the same time until the Service can determine which is applicable in each particular case. The two notices were sent from separate Service Centers so this presumably did not occur here, but no one is certain. When the District Counsel does advise the Service Center to issue both notices, no record is kept so the transaction can be examined promptly to determine which is applicable. Again, the court may determine the Service is not substantially justified in not examining whether the TEFRA provisions are applicable very soon after sending out notices of deficiency to the partners and the notice of final partnership adjustment at the same time.

Notwithstanding Sher, because of these two factors, this case does not represent a good litigating vehicle with which to advance the "position of the United States" at the administrative level argument in the TEFRA area.

3. Exhaustion of Administrative Remedies

Since a 30-day letter was not sent to the petitioners, they could not elect to attend an Appeals office conference. See Treas. Reg. § 301.7430-1(b)(ii). Therefore, these petitioners exhausted the administrative remedies available to them in the Internal Revenue Service. See LEM 7059.1 CHG 126, Litigation Guideline Memorandum re. Frivolous Petitions; Assertion of the Penalty under Code Section 6673.

We concur in your decision to settle this case and pay a maximum of $[redacted] in litigation costs. In light of the Sher decision, the possibility of the petitioners prevailing on the motion for award of litigation costs has been sharply reduced. We therefore recommend trying to settle the case for less than $[redacted].

If you have any further questions, please contact Helen F. Rogers of this office at FTS 566-3521

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